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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1966

No. 404

FREDERICK J. VILLAFRANCA and THELMA K. VILLAFRANCA, Husband and Wife, - - - - - - - - - Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE. - - - - - - - Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1966

No. _____

FREDERICK J. VILLAFRANCA and
THELMA K. VILLAFRANCA, Husband
and Wife, - - - - - *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, - *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals entered in the above case on May 4, 1966.

CITATIONS TO OPINIONS BELOW.

The Memorandum, Finding of Facts and Opinion of the Tax Court, numbered by it as T. C. Memo 1965-18, is not officially reported but is unofficially reported in the Commerce Clearing House Publication, 24 Tax Court Memorandum Decisions (TCM) 76, and in the Prentice Hall publication, 1965 T. C. Memorandum

Decisions ¶ 65.018. The opinion is printed in Appendix B hereto, infra, p. 21.

The opinion of the Circuit Court of Appeals, printed in Appendix B hereto, infra, p. 19, is reported in 359 F. 2d 849.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered May 4, 1966. Rehearing was denied on June 2, 1966. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED.

Whether an accrual basis partnership engaged in the business of selling dancing lessons which accrues into income, as received, all cash receipts from sales in accordance with this Court's decision in *Schlude* v. *Commissioner*[1] may deduct in the year of sale the minimum identifiable labor costs of producing the income so reported, notwithstanding that the actual instruction may not be rendered until after the taxable year.

STATUTES INVOLVED.

The statutory provisions involved are Sections 441(a), 446 and 461(a) of the Internal Revenue Code of 1954, being 26 U.S.C. Sections 441(a), 446 and 461(a) and 68A Stat. 148, 68A Stat. 151, and 68A Stat. 157. They are printed in Appendix A, infra.

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[1] 372 U. S. 128 (1963).

STATEMENT.

The petitioners are equal partners in a business known as Arthur Murray School of Dancing, Louisville, Kentucky, a calendar year partnership engaged in selling dancing instruction. The partnership operated two dancing studios in the year 1959, one in Louisville, Kentucky, and one in Lexington, Kentucky (Stipulations 1 and 2, pp. 19a-20a). The Lexington studio was sold in 1960, including the backlog of untaught hours (Petitioners' Exhibit 9,[3] R. 44a-45a). Other than reporting income for Federal Tax purposes, the partnership's books and records were kept on the accrual method. For tax purposes, its normal method of accounting was adjusted by including into income all cash received during an accounting period, whether or not earned. Expenses were reported for bookkeeping and for tax purposes alike on the accrual basis (R. 37a-39a).

The deficiency herein arises from an increase in the taxpayers' distributable net income from the partnership by reason of the disallowance of four deductions from the partnership's income for the year 1959 (Exhibit A to Petition, R. 11a-12a).

The only significant deduction disallowed by the respondent is an item deducted from the partnership's gross income under the label "Provision For Teaching

[3]This chart was reproduced in Petitioners' Statement of Facts on brief in the Circuit Court of Appeals and for that reason was not included in the printed appendix to that brief which is part of the record certified herein. Exhibit No. 9 is reproduced in Appendix C hereto, infra p. 26.

Expense" in the amount of $27,625.00 (Exhibit 2-B to Stipulation, R. 21a-22a). This deduction was computed on the basis of $2.00 for each of 13,812½ untaught hours of instruction sold by the partnership pursuant to written contracts with its students during the year 1959 and remaining untaught as of December 31, 1959 (Stipulation No. 5, R. 20a). Each written contract provided for a specified number of hours of dancing instruction to be furnished by the partnership at a specified price (Stipulation No. 4, R. 20a; Exhibits 3-C and 4-D, R. 23a and 24a).

The partnership maintained records on each individual student, reflecting the number of hours sold, the dates on which each portion thereof was taught (R. 28a-30a).

Petitioners' Exhibit No. 9, showing how the 13,812½ hours of teaching instruction sold by the partnership during the year 1959 and remaining untaught as of December 31, 1959, were subsequently taught or disposed of, is reproduced in Appendix C hereto at p. 26, infra.

Dancing lessons were scheduled, if possible, on a minimum basis of four hours of teaching per week, this being the minimum program containing sufficient continuity to best develop dancing ability (R. 27a).

The partnership used an effective follow-up procedure to keep students active without regard to the manner in which they paid for their lessons (R. 30a, 34a-36a). It hoped to enjoy the benefit of word of mouth recommendations (R. 27a).

Teachers were paid by the hour on an increasing scale for every hour taught, whether or not the student paid for his current instruction, as an incentive to inspire students to complete the entire course. The pay rate was never less than $2.00 per hour (R. 28a, 36a and 44a).

It was impractical for the partnership to teach all the hours of instruction during the year in which they were sold because it was impossible for the students enrolling in the latter part of the year to take the lessons contracted for within the balance of the calendar year (R. 30a-31a).

Customers or students of the partnership paid during the calendar year 1959 for a total of 9,444 hours of the 13,812½ unperformed hours of teaching instruction sold by the partnership prior to December 31, 1959 (Stipulation No. 6, R. 20a).

Prior to 1956, the Federal return of income of the partnership was prepared on the "strict accrual basis" in the same manner as the books were kept (R. 39a-40a). In March, 1956, as a result of an audit by an agent of the Internal Revenue Service, the Treasury Department addressed separate letters to the petitioners and to the partnership enclosing a report of a revenue agent changing the method of reporting the partnership income by requiring all cash received, whether or not earned, to be included in the gross income. The taxpayer did not protest the adjustments required by the Revenue Agent's report because the taxpayer's certified public accountant was familiar with the decision of *Curtis R. Andrews*. 23 T.C. 1026

(1955), wherein the Treasury Department was successful in requiring like changes in the method of reporting gross income of an Arthur Murray Studio. In 1959, the "Provision For Teaching Expense"[1] was integrated into the accounting system by the partnership's certified public accountant to more realistically reflect net income, to provide for a matching income and expenses and to prevent distortion (R. 40a-41a).

Notwithstanding that the cost of teaching the untaught hours in the years subsequent to 1959 would include the general overhead such as rent, utilities, telephone, and advertising, the $2.00 an hour factor was selected by the accountant because it represented the absolute minimum per hour labor cost of teaching the untaught hours in years subsequent to 1959 (R. 44a).

The actual labor factor in the cost of teaching untaught hours in the years subsequent to 1959 ranged from $3.08 to $3.53 per hour (R. 46a).

In years subsequent to 1959 in which the untaught hours of teaching instruction sold during the year 1959 were taught, sold, or written off, the method of accounting employed by the partnership required that the deduction for expense of teaching students these hours be reduced by $2.00 per hour previously deducted in 1959 to avoid the double deduction for this expense (R. 43a-44a).

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[1]This is the actual label used on the 1959 partnership return operating statement (Exhibit 2B to Stipulation, R. 21a-22a). However, the balance sheet contained in the partnership return carried an asset labeled "Teaching Expense-Reserve" in the same amount and the Circuit Court of Appeals and the Tax Court used this label in referring to the deduction (Appendix B, infra pp. 21-22).

At the hearing, petitioners introduced their Exhibit No. 16 to illustrate a comparison of the income tax effect of the accrual method, the return method of accounting and the Commissioner's method. Petitioners also introduced Exhibit No. 15 in an effort to demonstrate that the Commissioner's method would not leave the petitioners sufficient after tax dollars to perform in subsequent years the obligations undertaken by the partnership pursuant to the various written contracts made with its students in 1959. In preparing the brief before the Circuit Court of Appeals, petitioners included a reproduction of their Exhibits 15 and 16 in the Statement of Facts and for that reason these two Exhibits were not also included in the printed appendix to that brief and have not been included in the record certified to this Court. Petitioners Exhibits 15 and 16 are reproduced in Appendix C to this petition at pages 26 and 27, *infra*.

REASONS FOR GRANTING THE WRIT.

1. The opinion of the Sixth Circuit affirming the Tax Court's decision herein raises an issue as to the continued efficacy of this Court's decisions in the leading cases of *Dixie Pine Products Co.* v. *Commissioner*, 320 U. S. 516 (1944), *Security Flour Mills* v. *Commissioner*, 321 U. S. 281 (1944) and *U. S.* v. *Anderson*, 269 U. S. 422 (1926). These three cases established the "all events test" for the accrual and deductability of obligations for income tax purposes. This test stands for the proposition that an accrual basis taxpayer may deduct obligations in the year all events occur which

establish the taxpayer's definite liability to pay a debt or to perform an obligation.

The partnership in the instant case received full payment in 1959 for 9,444 hours of the dancing instruction to be rendered in subsequent years. Petitioners believe these facts meet the "all events test" in establishing a definite obligation to furnish the hours of instruction so sold.

In the instant case, both the Tax Court and the Sixth Circuit relied on the recent cases of *Schlude* v. *Commissioner*, 372 U. S. 128 (1963); *American Automobile Association* v. *Commissioner*, 367 U. S. 687 (1961); *Milwaukee and Surburban Transport Corp.* v. *Commissioner*, 367 U. S. 906, vacating and remanding 283 F. 2d 279 (CA 7, 1960) reversing TC Memo 1959-216, and *Simplified Tax Records, Inc.*, 41 T.C. 75.[1]

Where the time for performance of the service was uncertain, the *Schlude* case and the *American Automobile Association* case each determine that the time for accrual of "unearned income" from service contracts is the year of cash receipt, and this Court there held that the Commissioner has the authority to require a change in a taxpayer's method of accruing income if the tax method is found to be artificial notwithstanding its commercial acceptability. *Milwaukee and Surburban Transport Corp., supra,* involved an attempt by a transit company to deduct in the taxable year an estimated amount which it expected to pay in subsequent years on then existing unsettled tort claims.

[1]The Tax Court herein also cited *Automobile Club* v. *Commissioner*, 353 U. S. 180; *Marquardt Corporation*, 39 T. C. 443 and *Fifth and York Company* v. *United States*, 234 F. Supp. 421 (W.D. Ky., 1964) all accrual of income cases.

This Court remanded this case to the Seventh Circuit for a reconsideration in light of the *American Automobile Association* decision. On remand the Seventh Circuit[1] briefly affirmed the Tax Court's holding. The Tax Court had originally held that the unsettled tort claims were not deductible because during the year all the events had not occurred which established in the taxpayer a definite liability to pay such expenses nor could the amount of the liability be determined within the taxable year with reasonable certainty. The Tax Court relied on the *Dixie Pine Products Co.* and *Security Flour Mills* cases. Thus, the *Milwaukee and Suburban Transport Corp.* was decided under the all events doctrine.

In the instant case and in the *Simplified Tax Records, Inc.,* decision, the Tax Court stated there is no difference in deferring income and deducting estimated expenses, thus, not taking to account the fact the impact of the tax is on the net income. Notwithstanding that the partnership in the instant case had received payment in 1959 for 9,444 hours of instruction remaining untaught as of the end of the year, the Sixth Circuit stated herein that the partnership had not incurred any part of the deducted expense. Both decisions rely on the three recent accounting cases decided by this Court and *Simplified Tax Records, Inc., supra.*

It is apparent that the decisions of the Sixth Circuit and the Tax Court herein are based upon the Commissioner's authority to alter an accounting method under IRC Section 446(b), if in his opinion the same

[1]293 F. 2d 628 (1961).

does not clearly reflect the income, and upon an apparent finding that the taxpayers method of accounting was artificial. The lower Courts herein have, in effect, determined that the all events test has been superseded, although this Court in the *Schlude* and related cases did not in any way discard this test or mention the cases which establish the principle. The text of the *Simplified Tax Records, Inc.,* opinion indicates considerable uncertainty about this shift in principle.

2. Prior to the trial of the instant case, *Simplified Tax Records, Inc.,* 41 T.C. 75 (Oct. 17, 1963), was the only decision of any Court on accrual of deductions rendered after this Court's decisions in the *Schlude* v. *Commissioner, supra, American Automobile Association* v. *Commissioner, supra* and *Milwaukee and Surburban Transport Corp.* v. *Commissioner, supra.* The Sixth Circuit, as well as the Tax Court herein, cited *Simplified Tax Records, Inc.,* along with the three mentioned decisions of this Court as authority for their respective decisions herein. It is believed that the *Simplified Tax Records, Inc.,* case and the instant case seriously and erroneously extend the principles of the three mentioned decisions of this Court.

The taxpayer in *Simplified Tax Records, Inc.,* sold an accounting service which included books, business forms and an agreement of the vendor that it would prepare the subscribers income tax return for two years. The Tax Court held that the taxpayer could not accrue in the year of sale the expenses of preparing the income tax returns because the taxpayer prepared the

return for its subscribers only upon the request of the subscribers, thereby, introducing an accrual of income concept to a fixed liability which required no additional demand to create the obligation to perform for which that taxpayer had already been paid.

In the *Schlude* case and the *American Automobile Club* case the Supreme Court determined the taxpayers' methods of accruing income were artificial. *Milwaukee and Surburban Transport Corp.* actually involved an application of the all events test for accruing deductions. In the *Simplified Tax Records, Inc.,* case the Tax Court stated two bases for disallowance of the accrued deduction. Not only did it find the taxpayer's method of accounting for deductions to be artificial, but it also determined under the facts that the obligation to perform a contract did not occur upon receipt of a cash consideration but only upon actual performance. If all the events test had not been met, there was no need to find the taxpayer's accounting system to be artificial. On page 82 of its opinion, the Tax Court specifically distinguished the cases involving accrual of deductions for the cost of performing fixed contractual obligations in future years, to-wit: *Schuessler* v. *Commissioner,* 230 F. 2d 722 (C.A. 5, 1956), reversing 24 T.C. 247 (1955); *Pacific Grape Production Co.* v. *Commissioner,* 219 F. 2d 862 (C.A. 9, 1956), reversing 17 T.C. 1097 (1952); and *Denise Coal Co.* v. *Commissioner,* 271 F. 2d 930 (C.A. 3, 1959), affirming in part and reversing in part 29 T.C. 528 (1957), all of which were decided under the all events test. It is submitted that the real basis of the Tax

Court's decision in *Simplified Tax Records, Inc.*, is found in Footnote 6 to its opinion, which states as follows:

> "'[6]We suspect, because of its repeated emphasis on the Commissioner's discretion under sec. 41 of the 1939 Code and sec. 446 of the 1954 Code, and the legislative history of secs. 452 and 462, that the majority of the Supreme Court stand for the principle that, absent statutory sanction for it, unless the taxpayer can show that the Commissioner clearly abused his discretion in disallowing deferral of prepaid income or accural of estimated future expenses, this exercise of the Commissioner's discretion will not be disturbed by the Court even though the taxpayer's method of accounting is in accord with generally accepted principles of commercial accounting. We also suspect that this principle, if such it be, will meet with some resistance in the courts. See the dissenting opinions of Mr. Justice Stewart in *American Automobile Assn.* v. *United States,* 367 U. S. 687, 698 (1961), and *Schlude* v. *Commissioner,* 372 U. S. 128, 137 (1963), and the opinions of various Courts of Appeals in *Bressner Radio, Inc.* v. *Commissioner,* 267 F. 2d 520 (C.A. 2, 1959), reversing and remanding 28 T. C. 378 (1957), *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 697 (C.A. 10, 1955), reversing 21 T. C. 610 (1954), *Schuessler* v. *Commissioner,* 230 F. 2d 722 (C.A. 5, 1956), reversing 24 T.C. 247 (1955), and *Pacific Grape Prod. Co.* v. *Commissioner,* 219 F. 2d 862 (C.A. 9, 1955), reversing 17 T. C. 1097 (1952). The application of such a principle to the facts here would certainly require a decision for respondent on this issue." Footnote 6, *Simplified Tax Records, Inc.*, 41 T. C. 75, 81.

Under footnote 6 quoted above, the Commissioner is empowered to rearrange the time for taking deductions without a determination on his part that the taxpayer's accounting method is artificial and without regard to the all events test and subject to restraint only upon a showing that he has "clearly abused" his discretion. Thus, a taxpayer whose method of accounting is not artificial may yet find himself unable to demonstrate a clear abuse of discretion on the part of the Commissioner. An administrative officer armed with such authority may well feel obligated to exercise it.

The Tax Court itself was apparently uncertain in the conclusions reached in Footnote 6, and it is respectfully submitted that the implications of this Footnote, when applied to accrual of deductions, requires a limitation on the Commissioner's authority within the formal structure of the all events test.

3. An accrual method of accounting not providing for a matching of deductions for expenses incurred with respect to items of income required to be accrued or included into income for tax purposes subjects the taxpayer to a confiscatory gross income tax upon such items of income contrary to Congressional intent. In the *Schlude* and *American Automobile Association* cases, this Court found from the repeal of Sections 452 and 462 of the Internal Revenue Code of 1954 that Congress intended thereby to protect the revenues and to deny the deferral of reporting income until earned under the facts of those cases.

Mr. Justice Stewart in the dissenting opinion in the *American Automobile Association* case, pointed out

that the Senate Committee Report attending the repeal of these sections stated that uncertainty will exist by reason of the repeal and that the principles of *Pacific Grape Products* might well lead courts to permit the accrual of estimated expenses which would be covered by Section 462, even though this section is repealed, citing Senate Committee Report, 84th Congr. 1st Sess. S. Rep. 372 (1955) 1-11.

Petitioners respectfully request that this Court accept this case for review to round out guide lines on accounting methods by complementing its decisions in the *Schlude* and *American Automobile Association* accrual of income cases with a decision herein on accrual on deductions.

It is respectfully suggested to the Court that (i) a system of taxation based upon net income should permit and require a matching of income and expenses attributable to earning that income to avoid an effect of gross income taxation (ii) Congressional intent demonstrates that accrual of deductions of anticipated expenditures should continue notwithstanding repeal of Sections 456 and 462 of the Internal Revenue Code of 1954 and (iii) under a system of taxation based on net income, protection of the revenues is not involved where deductions for expenses of earning income are accrued in the year of sale to match the income from the sale required to be accrued in the same taxable year notwithstanding the year of performance of the contract.

4. Both the Tax Court and the Sixth Circuit mentioned in their respective opinions that the partnership had not applied for a change of accounting method for 1959, when the partnership introduced the "Provi-

sion for Teaching Expense" into its accounting system to balance the system after the changes effected by the Internal Revenue Service in 1955. The opinions of the Sixth Circuit and the Tax Court do not reflect that this "failure" to make application for a change of the accounting method was any basis for their respective decisions. Neither the statutory notice nor the Commissioner's pleadings raise this issue, and it was not before the Court, *Doric Co.* v. *Commissioner,* 341 F. 2d 967 (CA 9th, 1965).

The fact that the change was necessitated by the action of the Internal Revenue Service itself disposes of any such issue, *Gus Blass,* 9 T.C. 15 (Acq.).

CONCLUSION.

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A.

Internal Revenue Code of 1954:

SEC. 441. PERIOD FOR COMPUTATION OF TAXABLE INCOME.

(a) Computation of Taxable Income.—Taxable income shall be computed on the basis of the taxpayer's taxable year.

(b) * * *
(c) * * *
(d) * * *
(e) * * *
(f) * * *
(g) * * *

(26 U.S.C. 1958 ed., Sec. 441(a).)

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) Permissible Methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;
(2) an accrual method;
(3) any other method permitted by this chapter; or
(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) Taxpayer Engaged in More Than One Business.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1958 ed., Sec. 446.)

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) General Rule.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

(b) * * *
(c) * * *
(d) * * *
(e) * * *
(f) * * *

(26 U.S.C. 1958 ed., Sec. 461(a).)

APPENDIX B.

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 16535

FREDERICK J. VILLAFRANCA and THELMA K. VILLAFRANCA, Husband and Wife, - *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, - *Respondent.*

ON APPEAL from Decision of The Tax Court of the United States.

OPINION—Decided and Filed May 4, 1966.

Before WEICK, Chief Judge, CECIL, Senior Circuit Judge, and BOYD, District Judge.*

PER CURIAM. This proceeding is to review the decision of the Tax Court of the United States which sustained a deficiency determined by the Commissioner against the taxpayers in the amount of $18,512.50 in their income tax for the year 1959.

Taxpayers are husband and wife. They formed a partnership to sell dancing instructions in Louisville and Lexington, Kentucky, under the name of Arthur Murray School of Dance. They operated under franchise from Arthur Murray. They filed partnership income tax returns on an accrual basis.

*Marion S. Boyd, Chief Judge, United States District Court for the Western District of Tennessee, sitting by designation.

In 1959 the partnership sold thirteen thousand eight hundred twelve and one-half hours of dancing instructions, which remained untaught at the end of the year. They had received payment for nine thousand four hundred forty-four hours of instruction. In their partnership return they deducted from income $27,625.00 under the label "Teaching Expense—Reserve." They had not incurred any part of this deducted expense in 1959. The amount of the deduction was based on an estimated expense of two dollars per hour, multiplied by thirteen thousand eight hundred twelve and one-half hours. In the years subsequent to 1959 the actual expense of teaching, which averaged $3.08 and $3.59 per hour, was reduced by $2.00 per hour. It took about four years to teach all of the untaught hours, some of which were charged off as not claimed.

Prior to 1956 taxpayers reported as income only the amounts collected for which lessons were given. In 1956 the Commissioner required taxpayers to report all of the income which they received in each taxable year. It was not until 1959 that taxpayers took a deduction from income for the cost of lessons not taught in the taxable year. Taxpayers did not apply for nor obtain the consent of the Commissioner to the change in their method of accounting.

The Tax Court, in a Memorandum Findings of Fact and Opinion by Judge Forrester, reported in T.C. Memo. 1965-18, sustained the Commissioner. It relied on *Schlude* v. *Commissioner*, 372 U. S. 128; *American Automobile Ass'n* v. *United States*, 367 U. S. 687; *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U. S. 906; *Automobile Club* v. *Commissioner*, 353 U. S. 180; and its own decision in *Simplified Tax Records, Inc.*, 41 T.C. 75.

In our judgment the Supreme Court decisions cited by Judge Forrester compel the conclusion which the Tax Court reached. The decision of the Tax Court is therefore

Affirmed.

T. C. Memo. 1965-18

TAX COURT OF THE UNITED STATES

Docket No. 3692-62

FREDERICK J. VILLAFRANCA and THELMA VILLAFRANCA, - - - - - *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, - *Respondent.*

Irwin G. Waterman, for the petitioners.
Dennis M. Feeley, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION—

Filed February 3, 1965.

FORRESTER, *Judge*: The Commissioner has determined deficiencies in the petitioners' income tax for the calendar year 1959 in the amount of $18,512.52. Concessions have been made by petitioners and the sole remaining issue concerns the deduction in such year of $27,625 by petitioners' partnership as an estimate of the future costs of providing dance instructions to which a part of the 1959 income was attributable and which was labeled on the 1959 partnership return as "Teaching Expense—Reserve."

Some of the facts have been stipulated and are so found.

The petitioners are husband and wife residing in Louisville, Kentucky. They filed their joint Federal income tax return and the return for their partnership, which they owned equally and which was known as Arthur Murray School of Dancing, Louisville, Kentucky, with the district director of internal revenue, Louisville, Kentucky; each return covering the calendar year 1959.

Petitioners had owned and operated their partnership for a number of years prior to the year in issue and it was

at all relevant times engaged in the business of selling dancing instruction to its customers.

Such sales were made on the basis of individual "noncancellable" contracts, each of which (with unimportant exception) provided for a specified number of hours of such instruction.

The usual procedure upon the sale of a contract was for the partnership to set up a standing appointment with the student at the same time and on the same day or days of every week and far enough in advance to exhaust the number of hours called for by the contract. If possible, such schedules were set up on the minimum basis of 4 hours of instruction per week.

During the calendar year 1959 the partnership had, under such contracts, sold 13,812½ hours of dancing instruction which remained untaught at the end of such calendar year. During such year the partnership had received payment for 9,444 of these hours. The said 13,812½ hours were taught or disposed of as follows:

1960	Taught	7,192½
	Charged off	407½
1961	Taught	2,558
	Charged off	360
1962	Taught	870
	Charged off	174
	Sold or Taught	7,660*
1963	Taught	302½
	Charged off	None
	Carried on Inventory at 12/31/63	288
	Total	13,812½

*One of the studios operated by partnership together with its "business" was sold during 1962.

Students were urged to call ahead of time if they found it impossible to keep a scheduled appointment and the part-

nership was cooperative in rescheduling such an appointment. When a student simply failed to appear it was the partnership's practice to call him several times in an effort to get the appointments rescheduled and the student again active. This follow-up procedure was maintained without reference to whether the student's contract had been fully paid.

The partnership's teachers were paid on a per-hour per-student basis and without reference to whether or not the student's contract had been fully paid. During 1959 such teachers were paid at the rate of $2 an hour for the first 15 student hours taught in a given week, $3 an hour for the second 15 hours taught, and $3.50 an hour for all such hours over 30 which were taught in a week.

Individual student contracts usually provided for from 5 hours to 100 hours of instruction but some were much larger and provided for as many as 200 or 300 hours of such instruction.

Prior to 1956 the partnership had kept its books and prepared its Form 1065 (U.S. Partnership Return of Income) on an accrual basis which included receipts into income on the basis of hours taught rather than on the basis of cash received. In 1956 an agent of the internal revenue service audited the partnership's books and returns. Thereafter and for the year in issue the partnership reported as gross income on its return of income form, aforesaid, the amount of cash it had received during calendar year 1959. It continued to keep its books on the basis of taking receipts into income as hours of instruction were taught.

For the year in issue the partnership for the first time took as an expense to be deducted from gross income on its return of income form, aforesaid, a "Teaching Expense—Reserve" in the amount of $27,625. This provision for teaching expense for the year in issue included no overhead but was based solely upon the teachers' minimum pay of

$2 per hour multiplied by the number of hours remaining untaught as of the end of the calendar year 1959.

In years subsequent to the year in issue the actual expense of teaching these hours was reduced by $2 per hour as such hours were taught, sold, or written off. The teachers' actual remuneration for teaching these untaught hours in the 4 years subsequent to 1959 averaged between $3.08 and $3.59.

The statutory deficiency notice to these petitioners recites in pertinent part that ordinary net income distributable to them from the partnership is increased by adding the reserve for teaching expense in the amount of $27,625 to the ordinary net income reported by the partnership since such amount was an estimated figure of future costs or expense which was "not deductible until paid or incurred."

Petitioners' postition is summarized in their petition as follows:

> "By reason of the partnership's obligations to render dancing lessons pursuant to said written contracts, the said partnership incurs a fixed and certain liability to render dancing lessons to its customers at the time of the execution of each such written contracts.
>
> * * * * * * * *
>
> "As of December 31, 1959, the partnership had a fixed and certain liability to perform 13,812½ hours of teaching instruction * * * said liability being the number of hours of instruction sold during the said calendar year and then remaining untaught, and as of December 31, 1959, the minimum expense which would be incurred in the teaching of said lessons in the ensuing year was $2.00 per hour, which liability is deductible as an expense from the income of the said partnership during the calendar year 1959."

Petitioners initiate as an alternative argument on brief that since 9,444 of the untaught 1959 instruction hours had

actually been paid for and reported as a part of gross receipts by partnership for 1959 that partnership is entitled to deduct as an accrued business expense in such year at least the sum of $18,888 based upon the same $2 per hour for teaching expense.

We have here yet another in a long line of cases recently coming before the courts and involving either deferral of income or accrual of expenses to cover the estimated costs of rendering service in the future. *Schlude* v. *Commissioner*, 372 U. S. 128; *American Automobile Assn.* v. *United States*, 367 U. S. 687; *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U. S. 906; *Automobile Club* v. *Commissioner*, 353 U. S. 180; *Marquardt Corporation*, 39 T.C. 443; *Fifth and York Company* v. *United States*, 234 F. Supp. 421 (W.D. Ky. 1964).

We said in *Simplified Tax Records, Inc.*, 41 T.C. 75, 79:

> "While it can be argued that there are technical distinctions in deferring prepaid income and deducting estimated future expenses in cases like this the net result is the same and we think the same principles of tax accounting and the Commissioner's authority should be applied to both techniques.[3] As said in *American Automobile Assn.* v. *United States, supra*, the prepaid dues were credited to a reserve 'as deferred or unearned income reflecting an estimated future service expense to members.' [Footnote omitted.]"

This observation is equally applicable here.

We feel that there is no valid basis upon which the instant case can be distinguished from *Simplified Tax Records, Inc., supra*, and in this regard we make no distinction between petitioners' main and alternative arguments; consequently, on the authority of such case and of the other cases cited above,

Decision will be entered for the respondent.

DECISION—Entered February 3, 1965.

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed February 3, 1965, it is

ORDERED AND DECIDED: That for the calendar year 1959 there is a deficiency in income tax in the amount of $18,512.52.

(s) Bruce M. Forrester,
Judge.

APPENDIX C.

PETITIONERS' EXHIBIT No. 9.

SCHEDULE SHOWING THE TAXABLE YEARS IN WHICH THE 13,812½ HOURS OF TEACHING INSTRUCTION REMAINING UNTAUGHT AS OF DECEMBER 31, 1959 BUT SOLD BY THE PARTNERSHIP, ARTHUR MURRAY SCHOOL OF DANCING, DURING THE CALENDAR YEAR 1959 WERE TAUGHT AND DISPOSED OF.

		Louisville	Lexington	Total
1959	Hours on Inventory—12/31/59	8,807½	5,005	13,812½
1960	Taught	4,552½	2,640	7,192½
	Charged Off	202½	205	407½
1961	Taught	2,158½	399½	2,558
	Charged Off	259½	100½	360
1962	Taught	870		870
	Charged Off	174		174
	Sold at 12/31/62 or taught		1,660	1,660
1963	Taught	302½		302½
	Charged Off	—		—
	Carried on 12/31/63 Inventory	288		288
		8,807½	5,005	13,812½

PETITIONERS' EXHIBIT No. 15.

ARTHUR MURRAY SCHOOL OF DANCING SCHEDULE SHOWING AVAILABILITY OF AFTER TAX DOLLARS FOR 1959 FOR ACTUAL COSTS OF TEACHING HOURS CARRIED OVER FROM 1959 TO SUBSEQUENT YEARS.

Net Taxable Income—Includes Other Income:	
Less Personal Deductions and Exemptions	$62,968.00
Less—Income Taxes for 1959	31,518.64
Net after Income Taxes	$31,449.36

	1960	1961	1962	1963	Total
Hours Carried Over from 1959 and Taught in Subsequent Years	7,192½	2,558	870	302½	10,923
Cost Per Hour of Teaching	3.53	3.59	3.54	3.08	
Total Cost of 1959 hours Taught in Subsequent Years	25,389.53	9,183.22	3,097.80	931.70	38,584.25

PETITIONERS' EXHIBIT No. 16.

COMPARISON OF NET INCOME AND INCOME TAXES THEREON FOR ACCRUAL, PER FILED RETURN, AND COMMISSIONER'S METHOD.

	Accrual	Per Return	Per Commissioner's Determination
Gross Income	$263,052.17	$305,223.46	$305,223.46
Total Expense	252,489.64	240.859.29	240,859.29
Balance	10,246.78	64,364.17	64,364.17
Other Expense and Deductions Teaching Expense		27,625.00	
Balance	10,246.78	36,739.17	64,364.17
Other Taxable Income—add	4,761.70	4,761.70	4,761.70
Other Deductions—Deduct	4,357.87	4,357.87	4,357.87
Exemptions—Deduct	1,800.00	1,800.00	1,800.00
Taxable Income	8,850.61	35,343.00	62,968.00
Income Tax—Federal	1,901.16	12,071.50	28,280.16
State	00	1,083.72	3,238.47
Total Income Taxes	1,901.16	13,155.22	31,518.63
Net After Income Taxes	6,949.45	22,187.78	31,449.37

$27,625 in tax bracket of 50% to 62%—average 56%

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 404

FREDERICK J. VILLAFRANCA AND THELMA K. VILLAFRANCA, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

This income tax case presents a familiar tax accounting question—whether an accrual basis taxpayer is entitled to deduct a "reserve" for estimated future expenses.

Petitioners are members of an accrual basis partnership which conducts an Arthur Murray School of Dancing in Louisville, Kentucky. Prior to 1956 the partnership reported as gross income only amounts collected with respect to which lessons had already been given. Beginning with 1956 it reported as gross income the total amount received in each year—without regard to whether the lessons had already been

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given. For 1959 (the taxable year here involved) the partnership for the first time claimed a deduction, under the label "Teaching Expense-Reserve," for an estimated amount of future expenses to be incurred in furnishing lessons. (Pet. 20, 21–24.) The Commissioner disallowed this claimed deduction on the ground that the reserve represented estimated expenses "not deductible until paid or incurred" (Pet. 24). The Tax Court, relying chiefly upon this Court's decisions in *Schlude* v. *Commissioner,* 372 U.S. 128, and *American Automobile Assn.* v. *United States,* 367 U.S. 687, sustained the Commissioner's determination (Pet. 24–25). The court of appeals affirmed, holding that those decisions "compel the conclusion which the Tax Court reached" (p. 20).

The decisions of this Court in *Schlude* and *American Automobile Assn.* are dispositive of the instant case, and the decision below is in complete accord with those decisions. Whatever conflict previously existed was resolved by those cases, and there is no occasion for further review by this Court.

1. This case presents basically the same tax accounting question as was decided by this Court in *Schlude* and *American Automobile Assn.* In those cases taxpayers claimed exclusion from gross income (*i.e.,* deferral) of cash received in advance for future services, whereas here petitioners claim a deduction from gross income for estimated future expenses. The Court's rationale in *Schlude* and *American Automobile Assn.* applies with equal force whether the taxpayer seeks to exclude advance receipts from income

or to reduce them by the amount of estimated future expenses.

In *Schlude* the Court refused to permit a dance studio to defer cash received for dance lessons on non-cancelable contracts until the lessons were performed. The Court found such a method of accounting "artificial," since "at the end of each [tax] period, * * * the studio was uncertain whether none, some or all of the remaining lessons would be rendered" (372 U.S. at 135–136). Similarly here, petitioners' method of estimating the future expenses of giving lessons is equally "artificial," since petitioners were, at the end of each tax year, "uncertain whether none, some or all of the remaining lessons would be rendered" and thus whether the estimated expenses would ever be incurred. Indeed, the record shows that a number of students who had paid for lessons under non-cancelable contracts never demanded all of the lessons to which they were entitled (Pet. 22, 26).

This Court recognized that its decision in *American Automobile Assn.* was not limited to deferral of prepaid income, but extended also to the question in this case—the deductibility of estimated future expenses. Immediately after deciding *American Automobile* the Court remanded to the Seventh Circuit for reconsideration a case involving the deductibility of estimated future expenses. *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906. The Seventh Circuit, which had previously allowed a deduction for estimated future expenses (283 F. 2d 279), reversed itself on remand and denied the deduc-

tion (293 F. 2d 628). Even the dissenters in *American Automobile Assn.* recognized that after that decision a taxpayer "will have to include unearned receipts, *without any offsetting deductions for the future cost of earning those receipts*" (367 U.S. at 714, emphasis added).

Moreover, just as the repeal of 1954 Code § 452 (Deferral of "Prepaid Income") demonstrated a Congressional intent to preclude deferral of prepaid income, the contemporaneous repeal of correlative § 462 (Deductibility of "Reserves for Estimated Expenses") demonstrated a Congressional intent to prevent accomplishment of the same net result through the deduction route. See *American Automobile Assn.* v. *United States*, 367 U.S. at 694–697; *Schlude* v. *Commissioner*, 372 U.S. at 134. The front door to reduction of taxable net income having been closed by *American Automobile Assn.* and *Schlude*, petitioners may not reenter by the back door.

2. It is axiomatic that taxable income must be computed on an annual basis, and that a taxpayer may not accelerate the year in which he takes a deduction in an effort to reflect the anticipated long-term economic result of a particular transaction or group of transactions. See *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493, 498. An accrual taxpayer may claim a deduction only in the taxable year in which he has paid an expense or his liability to pay it has become fixed. See, *e.g.*, *Security Mills Co.* v. *Commissioner*, *supra*; *Brown* v. *Helvering*, 291 U.S. 193; *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516; *United States* v. *Ander-*

son, 269 U.S. 422; *Commissioner* v. *Hansen,* 360 U.S. 446.

Petitioners' contention (Pet. 7–10) that the decision below violates the "all events" test for determining the deductibility of an expense under the accrual method of accounting rests upon the erroneous assumption that a contractual obligation *to incur* an expense in a subsequent taxable year is the equivalent of *actually incurring* the expense in the current taxable year. Manifestly, petitioners incurred no fixed liability to their dancing instructors for lessons not yet furnished; such a liability would arise only when the instructors actually gave the lessons. Thus, the "reserve" created by petitioners merely reflected an estimate of future teaching expenses to be incurred, not a fixed liability. This Court has long recognized that "Many reserves set up by prudent business men are not allowable as deductions." *Brown* v. *Helvering, supra,* 291 U.S. at 202.[1]

3. Finally, the deduction for the first time in the partnership's 1959 return of a "reserve" for estimated future teaching expenses constituted a departure from its previous method of accounting (Pet. 20, 23). Yet

[1] See also *Lewyt Corp.* v. *Commissioner,* 349 U.S. 237, 242 (an accrual basis taxpayer may not take "events after the taxable year * * * into account"); *United States* v. *Consolidated Edison Co.,* 366 U.S. 380, 384; *Healy* v. *Commissioner,* 345 U.S. 278, 284–285; *Spencer, White & Prentis* v. *Commissioner,* 144 F. 2d 45 (C.A. 2), certiorari denied, 323 U.S. 780 ("liability for the work done after * * * [the taxable year] had not been incurred for the work had not been performed"); *Streight Radio and Television, Inc.,* v. *Commissioner,* 280 F. 2d 883 (C.A. 7), certiorari denied, 366 U.S. 965.

petitioners neither applied for nor obtained the consent of the Commissioner to such change in accounting method (Pet. 20), as required by the statute (1954 Code, § 446(e)).

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MITCHELL ROGOVIN,
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HARRY BAUM,
STEPHEN H. PALEY,
Attorneys.

SEPTEMBER 1966.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1966

No. 404

FREDERICK J. VILLAFRANCA and THELMA K. VILLAFRANCA, Husband and Wife, - - - - - - - - Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE, - - - - - - - - Respondent.

PETITION FOR REHEARING ON PETITION FOR CERTIORARI.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1966

No. 404

FREDERICK J. VILLAFRANCA and
THELMA K. VILLAFRANCA, Husband
and Wife, - - - - - - *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, - *Respondent.*

PETITION FOR REHEARING ON PETITION FOR CERTIORARI.

Petitioners are reliably informed that the taxpayer in Michael V. Lawless v. Commissioner of Internal Revenue, T.C. Memo 1966-12, 25 TCM 49,[1] has filed a petition for review to United States Court of Appeals for the Ninth Circuit for review of an adverse decision of the Tax Court in a case involving, among other issues, the right of a cash basis dance studio to deduct estimated future expenses of $2.50 per hour under prepaid dance instruction contracts for untaught lessons at the end of the taxable year. The Tax Court therein relied on the same authorities as it did in the instant case but did not mention its decision herein.

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[1]Tax Court Docket Nos. 92017, 1455-64 and 94364-94366.

The taxpayer in the instant case accrued as a deduction its obligations to its students for prepaid hours of instruction remaining untaught at the end of the accounting year. These obligations were measured by the minimum teaching expense of $2.00 per hour for each such untaught lesson.

Inasmuch as the Ninth Circuit may reach a result in the similar case before it which differs from the decision of the Sixth Circuit herein, it is respectfully requested that final action in the instant case be withheld and the petitioners' rights be preserved until it may be determined if a conflict shall occur in the Courts of Appeal on this issue.

It is believed that issues as to the continued viability of the all events test for accrual of deductions, the need for a decision on accrual of deductions to complement accrual of income decisions of this Court and an exploration of the limits of the Commissioner's power to require changes in tax accounting systems are all of sufficient importance to merit this Court's attention.

Respectfully submitted,

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Counsel for Petitioner.

Of Counsel:

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CERTIFICATE.

The undersigned counsel for taxpayers hereby certifies that this petition for rehearing on the Petition for Certiorari is not filed for purposes of delay and states that the petitioners' full tax liability claimed by the respondent has been fully paid after the decision of the Court of Appeals herein and upon levy and threat of execution thereon. It is further certified that the petition is restricted to the grounds urged in 54-55.

Of Counsel for Petitioners.

END